April 25, 2017

Gerald Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Advance Notice of Proposed Rulemaking

Dear Mr. Poliquin:

Boeing Employees' Credit Union ("BECU") appreciates the opportunity to comment on the National Credit Union Administration's ("NCUA") advance notice of proposed rulemaking ("ANPRM") regarding the inclusion of supplemental capital in the NCUA's risk-based net worth requirements, published in the Federal Register on February 8, 2017.[1]

I. Introduction and Summary

The adoption of a supplemental capital rule is a necessary adjunct to the NCUA's risk-based capital rules. Including supplemental capital in the NCUA's risk-based capital rules will help credit unions and their members, and will help protect the National Credit Union Share Insurance Fund ("NCUSIF" or "Fund") from potential losses.

The NCUA should adopt supplemental capital rules that establish clear prudential safety and soundness requirements, and must include investor protection and disclosure obligations consistent with the credit union mission. The rules should also maximize regulatory flexibility and allow credit unions to respond to market demands.

A bedrock principle for any supplemental capital offering is that it preserve the cooperative, mutual nature of credit unions. The NCUA should adopt a rule that establishes broad criteria applicable to all forms of supplemental capital, rather than authorizing specific instruments. The goal should be to maximize the flexibility of credit unions to respond to market demand, within defined parameters.

A flexible rule will benefit credit unions and the NCUA. Flexible rules will allow credit unions to develop supplemental capital offerings that are responsive to market demands. Flexibility will also ensure that the NCUA has broad discretion to review the supplemental capital plans of issuing credit unions to ensure that any planned offering includes appropriate safeguards and satisfies prudential safety and soundness requirements. The NCUA's supplemental capital rule should be scalable; the compliance burden should be proportionate to the size and complexity of the credit union and the issuance.

[1] 82 Fed. Reg. 9291 (Feb. 8, 2017).

The NCUA should model the rule, including the investor protection and disclosure provisions, on comparable rules and regulations developed for low-income designated credit unions ("LICUs"), borrowing as appropriate from rules adopted by the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Securities and Exchange Commission ("SEC"). Credit unions would benefit from clear compliance guidelines based on long-standing rules and practices that have developed with markets over time and are consistent with existing practices in adjacent marketplaces.

Supplemental capital will not be the solution to all capital problems, but having the option to count supplemental capital as part of the risk-based net worth requirements is important for credit unions and their members. The market will follow the rule and the rule will likely need to be modified over time.

These comments respond to many of the questions raised in the ANPRM. BECU commends the NCUA Board and staff for undertaking a comprehensive review of this important issue. To help further the discussion BECU has included a draft set of supplemental capital regulations as part of its comments. The draft regulations are included for consideration. To be sure, these draft regulations can and should be refined and improved by the agency staff with the benefit of the comments filed in response to this ANPRM.

II. Discussion

A. The NCUA has the Authority to Include Supplemental Capital in its Risk-Based Capital Rules

1. The FCUA Requires the NCUA to Develop Two Distinct Measures of Capital Adequacy

Section 216 of the Federal Credit Union Act ("FCUA" or "Act") requires the NCUA to promulgate net worth requirements that are comparable to capital requirements promulgated by the bank regulatory agencies under Section 38 of the Federal Deposit Insurance Act ("FDI Act").[2] Such rules must include two distinct measures of capital adequacy: (1) a "net worth ratio" (or leverage ratio) of net worth to total assets[3] and (2) a risk-based net worth requirement for credit unions that are complex.[4]

The FCUA provides specific definitions of the terms "net worth" and "net worth ratio."[5] Separately, the FCUA requires the NCUA to develop a "risk-based net worth requirement for complex credit unions."[6]

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[2] *See* Pub. L. 81–797, 64 Stat. 873 (Sep. 21, 1950), codified at 12 U.S.C. § 1831o.

[3] 12 U.S.C. §§ 1791d(c), 1791d(o)(3).

[4] 12 U.S.C. § 17901d(o)(1).

[5] The FCUA provides in pertinent part:

"Net worth.—The term "net worth"—

The explicit definitions of "net worth" and "net worth ratio" apply only to the leverage ratio requirement. The FCUA does not include specific definitions for risk-based net worth requirements. Rather, the NCUA is required to develop a "risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."[7]

2. The NCUA Has Broad Authority to Include Supplemental Capital in Its Risk-Based Capital Framework

Because the risk-based capital ratio is not limited by the statutory definition of "net worth," there is nothing in the FCUA that precludes an interpretation allowing for adjustments to net worth for risk-based net worth requirements, including adjustments to include supplemental capital components. Accordingly, the ANPRM correctly concludes that the NCUA has broad discretion to include supplemental capital as part of its risk-based net worth requirements.[8]

The NCUA has exercised this discretion to require adjustments to the numerator in the risk-based capital ratio that are different from net worth as defined by the FCUA for the leverage ratio (net worth) requirements (i.e., retained earnings as determined in accordance with generally accepted accounting principles ("GAAP"), and certain other components). For example, the final rule allows the inclusion of loan loss reserves in the numerator for the risk-based net worth ratio, but would generally require deductions for goodwill, other intangible assets, and the NCUSIF

"(A) with respect to any insured credit union, means the retained earnings balance of the credit union, as determined under generally accepted accounting principles, together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined;
"(B) with respect to any insured credit union, includes, at the Board's discretion and subject to rules and regulations established by the Board, assistance provided under section 1788 of this title to facilitate a least-cost resolution consistent with the best interests of the credit union system; and
"(C) with respect to a low-income credit union, includes secondary capital accounts that are—
(i) uninsured; and
(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund."[5]
"Net worth ratio.—The term "net worth ratio" means, with respect to a credit union, the ratio of the net worth of the credit union to the total assets of the credit union."[5]

12 U.S.C. § 1790(o)(3).

[6] The FCUA provides in pertinent part:

"Risk-based net worth requirement for complex credit unions.—
"(1) In general.—The regulations required under subsection (b)(1) of this section shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.
"(2) Standard.—The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."

12 U.S.C. § 1790d(d).

[7] 12 U.S.C. § 1790d(d)(2).

[8] *See* ANPRM at 19-20.

deposit.[9] Therefore, the NCUA has already embraced this discretion by including additional components in its risk-based capital numerator. It should use this same authority to include supplemental capital.

The FDI Act requires the bank regulatory agencies to impose (1) a regulatory "leverage limit," which is a "ratio of tangible equity to total assets,"[10] and (2) a "risk-based capital requirement."[11] Like the FCUA, the FDI Act mandates a leverage measure, based upon tangible equity capital, but commits the risk-based measure to the discretion of the regulatory agency. The bank regulatory agencies have used that authority to include supplemental capital in their risk-based capital rules. The NCUA should do the same.

For all of these reasons, the NCUA's decision to include supplemental capital in its risk-based capital rules would be a reasonable and appropriate interpretation of the FCUA and would be entitled to deference on judicial review.[12]

3. Comparable Risk-Based Capital Rules Must Recognize Supplemental Capital

The NCUA is required to develop risk-based net worth requirements that are "comparable" to risk-based capital requirements promulgated by the bank regulatory agencies.[13] Notwithstanding its discretion in developing risk-based net worth rules, the failure to include any provision for supplemental capital may violate the directive under Section 216 of the FCUA to develop requirements that are comparable to those applicable to banks under Section 38 of the FDI Act.

The final risk-based capital rule adopted by the NCUA is not comparable to bank regulations with respect to the inclusion of capital components available to absorb losses in the numerator of the ratio. The final rule allows negative adjustments, but unlike the regulations promulgated under the FDI Act, it does not allow positive adjustments such as the inclusion of supplemental capital components.[14]

Regulations promulgated under Section 38 of the FDI Act were explicitly designed "to improve the quality and quantity of regulatory capital and build additional capacity into the banking

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[9] 12 C.F.R. § 702.104(b)(1), (2).
[10] 12 U.S.C. §§ 1831o(c)(1)(A)(i), 1831o(c)(3).
[11] 12 U.S.C. § 1831o(c)(1)(A)(ii).
[12] *See Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *Amerada Hess Pipeline Corp. v. FERC*, 117 F.3d 596, 601 (D.C. Cir. 1997) ("Courts defer to agency interpretations in large part because Congress has chosen to delegate to the agency decision-making in the field."). *See also, Northeast Hosp. Corp. v. Sebelius*, 657 F.3d 1, 4 (D.C. Cir. 2011) (quoting *Nat'l Cable & Telecomm. Ass'n v. FCC*, 567 F.3d 659, 663 (D.C. Cir. 2009) (deferring to agency construction not "unambiguously foreclose[d]" by the statute)).
[13] 12 U.S.C. § 1790d(b)(1)(A).
[14] 12 C.F.R. § 702.104(b)(1), (2).

system to absorb losses in times of market and economic stress."[15] For example, the comparable bank regulations permit mutual depository institutions, which do not issue stock, to include instruments that meet specific criteria in common equity tier 1 capital.[16]

As pointed out in BECU's prior comments, the decision not to include supplemental capital components in the NCUA's risk-based net worth requirements fails the comparability standard on several levels. First, it is inconsistent with "comparable" regulations promulgated under Section 38 of the FDI Act because it does not account for capital instruments issued by institutions that do not issue stock. Second, and perhaps more importantly, it misses the opportunity to build additional risk absorption capacity into the credit union system to weather losses in times of market and economic stress, thereby missing the opportunity to further mitigate risk. As noted in the ANPRM, expanded options for credit unions to build capital beyond retained earnings would help protect the NCUSIF.[17] Third, unlike banks that can raise other forms of capital like common stock, credit unions (other than LICUs) facing pressure on capital levels have few choices other than increasing fees, making their loan rates less attractive to members, or shrinking assets. Therefore, allowing for supplemental capital in the risk-based capital numerator is even more important for credit unions than other financial institutions. This will be especially true staring in January 2019 when the increased risk-based capital net worth requirements become effective.

Accordingly, including supplemental capital in the NCUA's risk-based capital rules would be a reasonable and appropriate construction of the FCUA and would be consistent with the NCUA's obligation to promulgate capital rules that are comparable to other bank regulatory agencies.

B. Regulatory Flexibility is Necessary to Allow the Market for Supplemental Capital to Develop

The ANPRM opens with a series of questions regarding the current and prospective use of supplemental capital, the potential structure of supplemental capital instruments, and the potential viability and market demand of supplemental capital.[18] These are important considerations, but they are also, in a sense, premature. Many of these questions cannot be answered at the outset.

The benefits of supplemental capital are well documented.[19] Supplemental capital can serve as a tool to help well-managed credit unions meet their risk-based net worth requirements, which can

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[15] 78 Fed. Reg. 62018, 62021 (Oct. 11, 2013).
[16] *See* e.g., 12 C.F.R. § 324.22(b)(1).
[17] *See* ANPRM at 19.
[18] *See id.* at 13-18.
[19] *See* NCUA SUPPLEMENTAL CAPITAL WORKING GROUP, SUPPLEMENTAL CAPITAL WHITE PAPER (Apr. 12, 2010) (hereinafter "NCUA WHITE PAPER"); NASCUS, ALTERNATIVE CAPITAL FOR CREDIT UNIONS: WHY NOT? (2005); JAMES A. WILCOX, REFORMING CREDIT UNION CAPITAL REQUIREMENTS (Mar. 3, 2011); ROBERT F. HOEL, ALTERNATIVE CAPITAL FOR U.S. CREDIT

help individual credit unions meet their members' demands for affordable financial services. As the NCUA has acknowledged, "a credit union's inability to raise capital outside of retained earnings limits its ability to grow its field of membership and to offer greater options to eligible consumers."[20] Supplemental capital can help support the responsible growth plans of healthy, well-managed credit unions.

Supplemental capital can also enhance the resiliency of credit unions to adapt to changing market conditions. A variety of circumstances, including local economic fluctuations and unforeseen events, can lead credit unions to experience unexpected losses. As the NCUA has previously observed, the current strategies available to respond to such losses may carry negative consequences for credit union members and the broader community.[21] Supplemental capital would provide an additional option to help credit unions bridge difficult periods without unnecessarily curtailing member services.

At the credit union system level, supplemental capital has the potential to enhance safety and soundness by providing an additional layer of loss absorption capacity to help withstand losses to the NCUSIF. Supplemental capital can also help provide an indirect benefit to the Fund by spurring additional growth and allowing credit unions to spread costs over a larger asset base. If managed properly, this larger asset base (after accounting for the costs of supplemental capital instruments) should provide a credit union with additional earning power, thereby growing retained earnings at a faster pace than would otherwise be possible. The cumulative effect would be enhanced retained earnings over time, providing further capacity to absorb losses.

It is hard to predict the specific instruments that may be developed or the market demand for different types of offerings. The difficulty in predicting these types of issues weighs in favor of the development of a rule that establishes a flexible framework with broad but clear parameters. The NCUA should establish a rule that maximizes the ability of credit unions and investors to respond to market demand and which provides appropriate suitability and disclosure safeguards and protects the NCUSIF.

Clear rules and maximum flexibility will facilitate market innovation as credit unions identify different business strategies and develop new instruments and potential offerings. Market education with respect to credit unions as issuers will take time. Likewise, it will take time to develop a market for securities offered by credit unions. In terms of prospective offerors and purchasers, BECU can only share its own view, which is that it is interested to see what types of

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UNIONS? A REVIEW AND EXTENSION OF EVIDENCE REGARDING PUBLIC POLICY REFORM, FILENE RESEARCH INST. (2007).

[20] NCUA, REPORT TO THE HOUSE FINANCIAL SERVICES COMMITTEE ON THE FINAL RISK-BASED CAPITAL RULE 126 (2015).

[21] NCUA WHITE PAPER at 13 ("Currently, credit union strategies for recovery are limited to shrinking assets to achieve improved net worth ratios, reductions of share dividend rates raising loan rates, increasing fees, cutting operating expenses, selling assets, and merging the credit union – all of which have a negative member and community consequence.").

offerings may become available and it welcomes the opportunity to assess supplemental capital as another option to improve service for its members.

The risk that the availability of supplemental capital may have potential negative effects on low-income credit unions' access to secondary capital appears remote.[22] Potential purchasers of supplemental capital offerings will very likely be separate and distinct from the customary investors in secondary capital, which tend to be charitable foundations and other philanthropic-minded institutional investors.[23] In large part, this is a reflection of the different market and the different business rationale for secondary capital, which is meant to expand access to capital for low-income households rather than to generate a return for investors. Accordingly, it is unlikely that the issuance of supplemental capital would interfere with the market for secondary capital.

The ANPRM appropriately recognizes that the issuance of supplemental capital will not be without costs.[24] Individual credit unions will need to determine whether such costs make sense for their business. Of course, the approach that the NCUA takes in developing its supplemental capital rules will significantly influence the costs of offering such instruments. There is an inherent tension between more complex rules and increased costs. This gives rise to a concern that at some level unnecessary regulatory rigidity and increased compliance costs could stifle the market for credit union supplemental capital before it has a chance to develop. Flexibility is important because it allows the NCUA to develop a rule that recognizes that the regulatory complexity should be proportionate to the complexity and risk of the offering.

C. The NCUA Should Implement Supplemental Capital Rules Now; Additional Changes to Its Borrowing Rules Should be Pursued Separately

The ANPRM raises a number of questions with respect to the limits of the borrowing authority available for federal credit unions to issue supplemental capital, the scope of the existing borrowing rule for federal credit unions and the borrowing limits and the waiver processes currently in place for all federally insured state chartered credit unions.[25] All of these issues merit further examination and all will become increasingly important as the experience with supplemental capital progresses and matures.

Notwithstanding these issues, the NCUA should develop and implement initial supplemental capital rules now. Matters related to borrowing authority can and should be addressed in parallel and follow-on rulemakings.

Two practical considerations militate in favor of moving forward with a more focused rule at this stage. First, any effort to comprehensively address all of the related issues in the initial rule will likely result in a rule that becomes too complex and unwieldy. Expanding the scope of the rule

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[22] *See* ANPRM at 18.
[23] *See id.* at 33 *citing* 61 Fed. Reg. 378 (Feb. 2, 1996).
[24] *See id.* at 14.
[25] *See id.* at 20-23.

potentially jeopardizes the ability to implement an initial rule that can be put in place in time for the January 2019 effective date of the risk-based capital regime. As discussed in further detail below, the market for supplemental capital will likely develop and mature only after the rule is put in place. Accordingly, it is important for the NCUA to set out clear rules and guidance on supplemental capital well in advance.

A second, related point is that initial supplemental capital offerings are likely to be less complex as the credit union industry and state and federal regulatory authorities explore this new market. Even if the NCUA determines that the statutory borrowing authority limits supplemental capital offerings for federal credit unions to subordinated debt instruments, the value of the dual chartering system is that it will permit early innovation on behalf of federally insured state chartered credit unions that derive their authority from applicable state law and regulation. All credit unions can benefit from this innovation as new types of offerings are developed and marketed. Similarly, the need to remove or modify the borrowing limit on federally insured state chartered credit unions under section 741.2 is an issue that is unlikely to present immediate concerns especially in view of the existing waiver provision.[26]

D. The Potential Tax Implications Identified are Important, but Manageable

The ANPRM acknowledges that while federal credit unions are statutorily exempt from taxation under the FCUA,[27] federally insured state charted credit unions are exempt from federal income taxation under section 501(c)(14)(A) of the Internal Revenue Code (Code) as "[c]redit unions without capital stock organized and operated for mutual purposes and without profit."[28]

The ANPRM further acknowledges that the Code does not provide a clear definition of capital stock and, thus, questions whether the NCUA should include certain prudential limitations in its supplemental capital rule to prevent a credit unions from offering an instrument that could be construed as capital stock and, thus, inadvertently jeopardize its tax status.[29]

These are legitimate and appropriate concerns, but systemic or material risks to the NCUSIF are minimal. First, as noted in the ANPRM,[30] the number of credit unions that will likely issue supplemental capital is relatively small. Second, provided the NCUA adopts a rule that requires advance approval of any new offering, the NCUA will be in a position to scrutinize instruments that may be perceived to pose a risk.

Furthermore, the best evidence of how the Internal Revenue Service (IRS) may assess future supplemental capital offerings is the IRS's own prior letter rulings. Two prior IRS letter rulings, a 1997 request by U.S. Central Credit Union and a 2005 request by State Employees Credit

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[26] 12 C.F.R. § 741.2.
[27] 12 U.S.C. § 1768.
[28] 26 U.S.C. § 501(c)(14)(A).
[29] *See* ANPRM at 23-25.
[30] See *id.* at 17-18.

Union,[31] confirmed that issuing supplemental capital ("equity shares") would not impair the tax-exempt status of federally insured state chartered credit unions, provided that the instrument does not appreciate in value and does not convey a participating equity interest (e.g., voting rights or rights to participate in the management) in the credit union.[32]

These decisions appropriately make clear that there is nothing fundamentally incompatible with the status of a credit union as a not-for-profit cooperative and its ability to access supplemental capital. Indeed, effective capital management is essential for all cooperatives. All other federally insured depository institutions, including corporate and low-income designated credit unions have access to supplemental capital as do many other types of mutual institutions. Allowing natural person credit unions access to supplemental capital for risk-based capital purposes will increase safety and soundness, provide capital comparability, and add additional market discipline to the credit union industry.

At the same time, these decisions appropriately ground the tax exemption in the credit union's status as a not-for-profit financial cooperative and work in practical terms to ensure that the cooperative, mutual character of the credit union is preserved. As discussed below, BECU firmly believes that preservation of the cooperative nature of credit unions is a bedrock principle that should inform the NCUA's rule and any future supplemental capital offering.

The risks of having an instrument classified as capital stock will likely provide sufficient incentive for credit unions to avoid questionable offerings. To address potential tax implications and concerns regarding the preservation of mutual ownership structure, the NCUA's rules can and should make explicit, as discussed below, that any issuance under the supplemental capital rule be structured to preserve the cooperative nature of the credit union, including an explicit prohibition that instruments will not provide voting rights or otherwise convey a participating equity interest. These constraints can be included in the supplemental capital plan for advance approval by the NCUA.

BECU cautions against requiring credit unions to obtain a formal opinion from the IRS prior to an offering.[33] The response time for IRS letter ruling requests is highly uncertain, and likely more so in a future of federal budget cutbacks. The uncertainty and delay would negatively affect the ability of credit unions to timely introduce new offerings in response to market demands. As an alternative, the NCUA could require that credit unions supply an opinion from competent tax counsel that a new supplemental capital offering would not impair the credit union's tax status.[34]

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[31] *See* NASCUS, ALTERNATIVE CAPITAL FOR CREDIT UNIONS . . . WHY NOT? (2005) at 7.

[32] *See* P.L.R. 2005-30030 (May 2, 2005)(citing *La Caisse Populaire Ste. Marie v. United States*, 77-1 USTC P 9137 (D.N.H. 1976), *aff'd* 563 F.2d 505 (1st Cir. 1977); 31 Op. Att'y Gen. 176 (1917)).

[33] *See* ANPRM at 24.

[34] *See* App. A, proposed regulation sec. 702.115(a)(12)(B).

E. Investor Protection and Disclosure Issues are Fundamental

The ANPRM states that the NCUA Board believes supplemental capital would be considered a security for purposes of state and federal securities laws.[35] BECU agrees. Notwithstanding the exemption from the registration requirements of the Securities Act of 1933 ("Securities Act"), there are important investor suitability, protection, and disclosure requirements related to the offer and sale of supplemental capital.[36]

Imposing a requirement that credit unions "register" with the NCUA may be an unnecessary formality. The objectives of a registration regime could be accomplished by requiring, as discussed below, that credit unions submit a supplemental capital plan to the NCUA for advance approval before issuing any new supplemental capital offering.[37] The NCUA should mandate certain investor suitability, protection, and anti-fraud requirements, and minimum disclosure requirements as part of its supplemental capital rule.[38]

Member service is core to the credit union mission as a mutual, not-for-profit financial cooperative. It follows that investor protection and disclosure issues are more than just compliance objectives; they are an essential part of the credit union purpose.

The NCUA can draw from several existing models to inform the investor protection and disclosure requirements. The existing LICU secondary capital regulations are a logical starting point. Additionally, investor protection and disclosure requirements under the Securities Act could be referenced. Many other federal prudential bank regulatory agencies look to the requirements of the Securities Act and regulations promulgated by the SEC for guidance. For example, the FDIC policy statement regarding the use of offering circulars in connection with public distribution of securities by state banks refers to a number of SEC regulations, including

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[35] *See* ANPRM at 25.

[36] Section 3(a)(5) of the Securities Act exempts from the Securities Act;

> Any security issued . . . by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution.

In various no-action letters, the SEC staff did not recommend enforcement action with respect to securities issued by credit unions in reliance on the exemption in Section 3(a)(5). See, *e.g.*, Idaho Central Credit Union No-action Letter, Fed. Sec. L. Rep. ¶ 81.004 (publicly available Feb. 14, 1977) (CCH), Oregon Telco Credit Union No-action Letter (publicly available April 3, 1978). Reasoning of the SEC staff seemed to focus on the fact that the credit unions involved were subject to regulation and examination by the NCUA and the applicable state regulator.

[37] *See* App. A, proposed rule sec. 702.115(a)(12).

[38] *See id.*

those governing private placements of securities.[39] Part 16 of the regulations promulgated by the OCC also follows this approach.[40]

Although sales of securities issued by credit unions are exempt from the registration and certain other requirements of the Securities Act, such sales are nevertheless subject to the anti-fraud provisions of that statute. A body of related law has developed under the Securities Act and the SEC regulations. By adopting standards that are consistent with SEC regulations, the NCUA could provide credit unions with requirements that are no more onerous than what is required under existing law for other financial institutions, while at the same time providing investors with protections borne out of years of SEC experience. Credit unions would benefit from compliance with long-standing rules that have developed over time. Such requirements would also be consistent with existing practices in the marketplace.

1. Proportionate Mandatory Disclosure and Anti-Fraud Provisions Are Essential

The ANPRM specifically requests comments with respect to whether the NCUA rules should mandate investor disclosures and anti-fraud protections.[41] BECU believes these provisions are essential components of the rule and should be mandated as part of detailed application requirements, subject to advance approval by the NCUA.[42]

Again, the NCUA should draw heavily on the existing disclosure regimes in developing its rule. The proposed regulation included in Appendix A to these comments incorporates a modified version of the FDIC's policy statement regarding the use of offering circulars in connection with public distribution of securities by state banks.[43] The FDIC policy statement is intended to protect insured state nonmember banks against the risk of substantial capital loss or litigation that could occur in the event that bank securities are sold in violation of Section 10b of the Securities Exchange Act of 1934. The policy statement describes ways in which issuers can satisfy the antifraud provisions of the federal securities laws which require full and adequate disclosure of material facts.[44] For offerings to the public, the policy statement generally requires the use of an offering circular to provide a variety of specified information about the securities being offered for sale.[45] However, the policy statement also deems that its disclosure goals will be met if issuers follow the procedures set forth in several cross-referenced SEC regulations, including Regulation D (for nonpublic offerings).[46] Thus, the FDIC policy statement, and the adapted

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[39] Federal Deposit Insurance Corporation, Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities, 61 Fed. Reg. 46808, (Sep. 5, 1996) (hereinafter "FDIC Policy Statement").

[40] 12 C.F.R. § 16.1 *et seq.*

[41] *See* ANPRM at 29-30.

[42] *See* App. A, proposed rule sec. 702.115(a)(8)-(9), (12) and Apps. A and B.

[43] *See id.*

[44] *See* FDIC Policy Statement.

[45] *Id.*

[46] *Id.*

version of it in our proposed regulation, accomplishes the goal of establishing a system of proportionate disclosure that is tied to investor sophistication.

As an alternative, the NCUA could adopt regulations that parallel Part 16 of the OCC's regulations, which apply to the offer and sale of securities issued by national banks.[47] The OCC regulations are more prescriptive and systematic than the FDIC policy statement, but have the same effect of requiring robust disclosure for securities offerings to the general public, while permitting streamlined disclosure in appropriate circumstances. For example, the requirement to file a registration statement and prospectus with the OCC under Part 16 does not apply if an offering meets the requirements of the SEC's Regulation D.[48]

Either model could serve as a template and would, as the ANPRM appropriately notes, ensure that investor suitability, protection, and disclosure requirements are scalable such that the compliance burden is proportionate with the size and complexity of the credit union and the issuance.

2. Certification, Policies and Procedures, and Compliance Requirements

The NCUA Board should also require credit unions to develop policies and procedures to ensure ongoing compliance with anti-fraud requirements as a condition of any supplemental capital offering.[49] This could be accomplished as part of disclosure and acknowledgement provisions of the rules or as a specific certification as part of the supplemental capital plan submitted by the credit unions.[50] The same certification of compliance procedures could be used to ensure compliance with state securities laws and to protect against state securities fraud-based claims.

The NCUA rules should address other state and federal securities issues and other related issues by requiring credit unions to certify in the supplemental capital plan that they have adequate policies and procedures in place to adequately address all relevant compliance procedures (for example, compliance with state securities requirements for federally insured state chartered credit unions, maintenance of adequate directors and officers liability insurance coverage, and adoption of policies addressing compliance with investment contracts, communications, and information sharing).[51]

The questions in the ANPRM regarding registration requirements as broker-dealers or investment advisers could also be addressed in similar fashion. As noted in the ANPRM, federal credit unions cannot register as broker-dealers and cannot directly provide investment advice.[52] State chartered credit unions must look to their own state securities and licensing laws. Accordingly, it is sufficient for the NCUA rules to require that credit unions have policies and

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[47] 12 C.F.R. § 16.1 *et seq.*
[48] 12 C.F.R. § 16.7.
[49] *See* ANPRM at 30.
[50] *See e.g.*, App. A, proposed rule 702.115(a)(12)(A)(vii).
[51] *See* ANPRM at 31-32.
[52] *See id.* at 30, n.43.

procedures in place to avoid triggering investment advisor registration requirements and to effectively manage third party brokerage arrangements.[53]

F. Scalability and Proportionality are Essential for Effective Investor Suitability Rules

The ANPRM raises a number of investor suitability issues.[54] The experience of other federal financial regulators may serve as a sensible guide for the NCUA's consideration of these issues. As noted in the ANPRM, the OCC's rules are proportionate to the relative sophistication of the investor, as are the FDIC's;[55] less-sophisticated investors are protected among other ways by additional disclosures. In contrast, more sophisticated investors may receive streamlined disclosures.

Specifically, under the FDIC Policy Statement, the offer and sale of bank securities generally requires the filing of a detailed offering circular.[56] This level of disclosure should likewise address the NCUA's concerns with respect to the transparency of credit union operation and performance, as well as the complexity and risk of individual supplemental capital offerings.[57]

Recognizing that a lack of proportionality with respect to the compliance burden can have significant distortionary effects on the market, the FDIC Policy Statement provides a number of alternative pathways for compliance for issuances that do not otherwise pose the risks of an unrestricted public offering, such as nonpublic offerings conducted in accordance with the SEC's Regulation D.[58] These exemptions include their own safeguards.

A similar approach would be appropriate for the NCUA's supplemental capital rule. The proposed regulations attached to these comments illustrate how the NCUA might structure a scalable or tiered approach for institutional investors, accredited investors, credit union members, and other investors.[59] Similar to the FDIC rules, the NCUA rule should also set clear guidelines for required disclosures and manner of sale limitations.[60]

A tiered approach may also be appropriate for concentration limits that restrict the amount of supplemental capital that any single person, group, or entity can hold. A different limit or no limit may be appropriate for accredited investors. A waiver provision to allow the NCUA to make case-by-case determinations may also be appropriate.

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[53] *See e.g.*, App. A, proposed rule 702.115(a)(12)(A)(viii).
[54] *See id.* at 33-34.
[55] *See id.* at 33.
[56] FDIC Policy Statement.
[57] The NCUA implicitly recognizes the adequacy of such disclosures, stating in the ANPRM that the OCC's rules "in part, help provide a level of investor protection, particularly for less sophisticated, non-institutional investors." APNRM, at 33.
[58] FDIC Policy Statement.
[59] *See* App. A, proposed rule 702.115(a)(9); app. A to 702.115.
[60] *See id.*

As a general matter, permitting a broader range of investors from within (members) and without (nonmembers) the credit union system will ensure the greatest possible market for supplemental capital instruments and, as the GAO noted in its 2007 report, allowing outside investors may bring increased market discipline to the credit union system.[61]

G. Prudential Standards Should be Established within Broad Parameters that Maximize Flexibility and Innovation

The ANPRM appropriately recognizes that the function of supplemental capital is to protect the credit union and the NCUSIF and, thus, poses a number of questions as to the specific safety and soundness criteria that new forms of supplemental capital should be required to meet to be considered regulatory capital.[62]

For purposes of developing the supplemental capital rule, focusing on the general attributes of potential supplemental capital offerings is a sound approach. In contrast, a rule that prescribed specific instruments would quickly prove limiting and inflexible. The NCUA should adopt broad parameters that maximize the flexibility of credit unions to respond to market demand, while simultaneously providing appropriate safeguards and prudential standards.

In developing these broad parameters the NCUA can draw from its own experience with LICU secondary capital, its prior work on supplemental capital,[63] Congressional policy direction on supplemental capital,[64] and comparable standards promulgated under the FDI Act for mutual depository institutions.[65]

The parameters must reflect, in part, the unique status of credit unions as not-for-profit financial cooperatives. Again, a bedrock principle for any form of supplemental capital is that it preserves the cooperative, mutual nature of credit unions. In practice, this will mean that no form of supplemental capital will convey voting rights to non-members or alter the one-member, one-vote governance model of credit unions.

Additional criteria for any form of supplemental capital included in the risk-based capital numerator might include the following:

- it is uninsured;
- it is subordinate to all other claims against the credit union;
- it is available to be applied to cover operating losses of the credit union in excess of retained earnings;

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[61] GAO, CREDIT UNIONS: AVAILABLE INFORMATION INDICATES NO COMPELLING NEED FOR SECONDARY CAPITAL 18 (2004).
[62] *See* ANPRM at 34-37.
[63] *See* NCUA WHITE PAPER.
[64] *See e.g.*, H.R. 1244, 115th Cong. (2017).
[65] *See* 12 C.F.R. § 701.34.

- if it has a stated maturity, the initial maturity is at least five years;
- if it has a stated maturity, the risk-based net worth value is discounted as it approaches maturity;
- it is limited to a certain threshold, ensuring a minimum level of core, non-supplemental capital;
- it is subject to disclosure and investor protection requirements;
- it is offered by a credit union that is determined by the NCUA to be sufficiently capitalized and well-managed; and
- it may only be issued pursuant to prior regulatory approval.

As illustrated in the proposed regulations included in Appendix A of these comments, these core attributes can and should be set out as conditions for any form of supplemental capital.[66]

1. The Rule Should Establish Clear Guidelines on Prior Regulatory Approval

Prior approval is important to confirm that supplemental capital instruments meet applicable regulatory requirements, preserve the cooperative, mutual nature of credit unions, and contribute to the safety and soundness of the credit union system. The NCUA should follow the example of its existing secondary capital regulations for LICUs to require the submission of a "Supplemental Capital Plan" for each supplemental capital instrument that a credit union proposes to issue. This plan should describe the features of the instrument with specificity, and explain how it would satisfy the NCUA's regulations. The potential contents of this Supplemental Capital Plan are detailed in the proposed regulation that is included in the appendix to these comments. As with secondary capital, the NCUA would have the discretion to approve or disapprove of this plan within a reasonable period of time.[67]

Once a Supplemental Capital Plan has been approved by the NCUA, credit unions should have the authority to issue any supplemental capital instruments that are consistent with its terms. This latitude will minimize the burden on the NCUA to review and approve each issuance of supplemental capital – an undertaking that should not be necessary if the NCUA has already confirmed that the characteristics of a particular supplemental capital instrument are consistent with applicable regulatory requirements.

Credit unions should also be required to file a notice of any subsequent, previously-approved issuance with the NCUA, in order to permit accurate calculation of a credit union's risk-based capital ratio. The timeline for filing this notice, and the form it should take, should follow the

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[66] *See* App. A, proposed regulation sec. 702.115(a).

[67] Consistent with the rules applicable to secondary capital, regulations pertaining to supplemental capital should provide that if a credit union is not notified within 45 days of receipt of a Supplemental Capital Plan that the plan is approved or disapproved, the credit union may proceed to offer supplemental capital instruments pursuant to the plan. *See* 12 C.F.R. § 701.34(b)(2). *See* App. A., proposed regulations sec. 702.115(a)(13).

post-issuance notice procedures required by the OCC for bank issuances of subordinated debt.[68] The NCUA's regulations should establish a presumption that supplemental capital instruments may be counted toward a credit union's risk-based capital requirements provided that they are issued pursuant to a duly approved Supplemental Capital Plan.[69]

The NCUA should also consider streamlined review and approval processes for functionally equivalent offerings by credit unions that are deemed substantially similar (in terms of net worth classification, CAMEL ratings, etc.) to another credit union that has previously been approved to offer a specific instrument.

As noted above, supplemental capital should be a tool to support the growth of healthy, well-managed credit unions, rather than a crutch for financially weak credit unions. For that reason, we agree with the NCUA's observation that "supplemental capital should not be offered when a credit union is in danger of liquidation in the foreseeable future (e.g., 18 months) or under stress."[70] The regulation we have proposed would go one step further by stipulating that credit unions must be sufficiently capitalized in order to offer supplemental capital instruments.[71]

2. Subordination, Aggregate Limits, and Other Issues

a. Subordination

Supplemental capital must be uninsured and subordinate to all other claims against a credit union (other than secondary capital), and available to be applied to cover operating losses of the credit union in excess of retained earnings. Provided these conditions are met, the NCUA's regulations should provide flexibility to structure payment priorities within and between supplemental capital instruments in a way that meets the needs of credit unions and investors.[72]

As long as supplemental capital instruments remain subordinate as required by the Act, contractual subordination arrangements among investors should have no bearing on the loss absorption capacity of supplemental capital. As the NCUA notes, flexibility in payment priorities "could help credit unions attract investors of different risk tolerances and profiles" and thus contribute to a more vibrant market for supplemental capital instruments.[73]

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[68] *See* 12 C.F.R. § 5.47(h).
[69] *See* App. A., proposed regulations sec. 702.115(a)(15).
[70] NCUA WHITE PAPER at 18.
[71] *See* App. A., proposed regulations sec. 702.115(a).
[72] *See* App. A., proposed regulations sec. 702.115(a)(3).
[73] ANPRM at 39.

b. Aggregate Limits

Supplemental capital should, by definition, *supplement* retained earnings as a source of capital for credit unions. It should not become the primary component of regulatory capital. An aggregate limit based upon a credit union's retained earnings will assure a minimum level of core, non-supplemental capital (primarily retained earnings).[74]

Further, consistent with Basel criteria, U.S. bank capital standards, and the NCUA's existing secondary capital regulations, the net worth value of any supplemental capital instrument with a stated maturity should be discounted for risk-based capital purposes as the instrument reaches maturity. The schedule for recognizing net worth value that is included in the LICU regulations provides a suitable method for reflecting the increasingly limited utility of supplemental capital instruments as loss absorbing capital as the instruments approach maturity.[75]

Likewise, the NCUA's secondary capital regulations also provide guidance with respect to prepayment and call provisions.[76] As discussed in the NCUA White Paper, restrictions on redemption are important to ensure that capital remains available to help withstand losses to the NCUSIF.[77] The NCUA should follow the LICU regulations to provide that early redemption of supplemental capital instruments is subject to the NCUA's prior approval, conditioned on a showing that, among other things:

> (i) The credit union will have a post-redemption net worth classification of "adequately capitalized" or better under Part 702;
> (ii) The instrument being redeemed was issued at least two years prior to the proposed redemption date; and
> (iii) The proceeds from the supplemental capital account will not be needed to cover losses prior to final maturity of the instrument.

These conditions will allow the NCUA to prevent outflows of supplemental capital from distressed credit unions. The conditions also provide flexibility for prudent redemptions that do not present safety and soundness concerns. The prior approval mechanism could also be used to accommodate renegotiation or reissuance of instruments to reflect changed pricing and other terms.[78]

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[74] *See* App. A., proposed regulations sec. 702.115(a)(11).
[75] *See* 12 C.F.R. § 701.34(c)(2); See App. A., proposed regulations sec. 702.115(b)(3).
[76] *See* 12 C.F.R. § 701.34(a).
[77] NCUA WHITE PAPER at 18 ("Any early redemption by a credit union of supplemental capital (e.g., to reduce borrowing cost if capital is no longer needed) must be subject to approval by both NCUA as insurer and the primary state regulator, if applicable. This prevents collusion between the credit union and investor, or sympathy for the member, allowing exodus of capital when it may be needed to protect the NCUSIF.").
[78] *See* App. A., proposed regulations sec. 702.115(c).

c. Reciprocal Holdings

The supplemental capital rules should include prudent limits to mitigate the systemic risk of reciprocal holdings. As noted in the ANPRM, existing regulations governing the treatment of reciprocal holdings among national banks or federal savings associations may be used as a guide.[79]

d. Mergers

To the extent possible, the supplemental capital rules should not include "change of control" or other provisions that interfere with management's consideration of mergers and other strategic transactions. The OCC rules provide an attractive model. The OCC prohibits provisions or covenants that unduly restrict or otherwise act to unduly limit the authority of a national bank, or interfere with the OCC's supervision of a national bank, including provisions or covenants that:

> (iii) Provide[] for default and acceleration of the subordinated debt as the result of a change in control, if such change in control results from the OCC's exercise of its statutory authority to require a national bank to sell stock in that national bank, enter into a merger or consolidation, or be acquired by a bank holding company; [or]
>
> (iv) Require[] the prior approval of a purchaser or holder of the subordinated debt note in the case of a voluntary merger by a national bank where the resulting institution:
>
> (A) Assumes the due and punctual performance of all conditions of the subordinated debt note and agreement; and
>
> (B) Is not in default of the various covenants of the subordinated debt.

Given the different business purposes underlying the issuance of secondary capital and supplemental capital, however, it would not be appropriate to require supplemental capital instruments to be "paid out" to investors upon a merger, as provided by the current LICU regulations.[80] Rather, the NCUA should follow the example of its regulations for corporate credit unions, which provide that in the event of a merger, all capital instruments will transfer to the continuing credit union, unless otherwise provided in the merger or asset purchase agreement.[81] This approach will meet investor expectations while ensuring the continuity of credit union capital resources.

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[79] *See* ANPRM at 44, n.68 (citing 12 C.F.R. § 3.22(c)(3)).
[80] *See* 12 C.F.R. § 701.34(b)(9).
[81] 12 C.F.R. § 704.3(b)(7).

H. Follow-On Regulatory Changes Will be Necessary

As noted in the ANPRM, additional changes to the NCUA's regulations will be necessary to realize the full benefit of the supplemental capital rule. As pointed out in BECU's prior comment letter, a number of regulations limit the authority of a credit union to engage in various activities based upon the credit union's exposure to the activity in relation to its unimpaired capital and surplus or net worth.[82] In some cases, the limitation is prescribed in statute and cannot be changed by regulation (e.g., member business lending). In many other cases, however, the limitation is imposed by regulation. In those cases, the NCUA could exercise its discretion as to whether the limit should be modified. Reference to risk-based capital in these cases would help credit unions realize the full benefit of supplemental capital.

For ease of reference, the chart BECU prepared showing a number of these provisions is provided again as Appendix B to this comment letter.

III. Conclusion

For the reasons discussed above and in its previous comments, BECU respectfully urges the NCUA to move forward with the development and implementation of its supplemental capital rule. The NCUA has the authority to include supplemental capital in its risk-based capital rules and doing so will help credit unions and their members and will help protect the NCUSIF from potential losses.

BECU looks forward to continuing to work with the NCUA on these important issues.

Thank you for your consideration of these comments.

Sincerely,

Mike Ryan
General Counsel & Corporate Secretary
Boeing Employees' Credit Union

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[82] Letter from Parker Cann, BECU, to Gerald Poliquin, NCUA (Apr. 27, 2015).

APPENDIX A

APPENDIX A

Risk-Based Supplemental Capital for Credit Unions

Proposed Amendments to NCUA's Risk-Based Capital Rule

Proposed Amendment	Explanation
§ 702.104 — Risk-based capital ratio. Amend § 702.104(b)(1) by adding a new subparagraph (ix) to read as follows: (ix) Supplemental capital accounts (established pursuant to § 702.115). Amend § 702.104(b)(2) by adding a new subparagraph (v) to read as follows: (v) Supplemental capital accounts established pursuant to § 702.115 which comprise investments in the capital of other credit unions held reciprocally, where such reciprocal cross holdings result from a formal or informal arrangement to swap, exchange, or otherwise intend to hold each other's capital instruments, by applying the corresponding deduction approach.	Section 702.104(b)(1) of the risk-based capital (RBC) rule lists the elements of the risk-based capital ratio numerator. The ratio between the numerator and a credit union's total risk-weighted assets as described in section 702.104(c) establishes a measure of a credit union's risk-based capital adequacy that is used to classify a credit union as "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized." The proposed amendment to section 702.104(b)(2) is meant to address the risk of reciprocal holdings and is modeled on the rules applicable to national banks and federal savings associations under 12 C.F.R. § (c)(3).
Amend subpart A of Part 702 to add a new section as follows: **§ 702.115 — Supplemental capital.** **(a) Supplemental capital instruments issued by credit unions.** For federally insured credit union classified as [INSERT] under § 702.102(a)(2), supplemental capital accounts established for risk-based capital purposes may include net proceeds from the sale of supplemental capital instruments offered pursuant to this section and subject to the following conditions:	Proposed section 702.115 would add a new definition of "supplemental capital" for the purpose of determining the types of capital to include in the risk-based capital ratio numerator under section 702.104(b)(1). The proposed amendment would provide NCUA with discretion to specify the capital adequacy classification of credit unions that may offer and accept supplemental capital.

		NCUA's Supplemental Capital White Paper[1] suggests requiring credit unions to be at least adequately capitalized per prompt corrective action (PCA) standards.[2]
	(1) ***Nonshare account.*** Proceeds from the sale of a supplemental capital instrument by a credit union will not be considered as a share or deposit account for any purpose.	This follows the LICU regulations (sec. 701.34(b)(3)).
	(2) ***Uninsured proceeds.*** Proceeds from the sale of a supplemental capital instrument will not be insured by the NCUSIF.	This follows the LICU regulations (sec. 701.34(b)(5)).
	(3) ***Subordination of claim.*** A supplemental capital instrument investor's claim against a credit union is subordinate to all other claims including those of share account holders, depositors, creditors and the NCUSIF, except claims of secondary capital account investors.	This follows the LICU regulations (sec. 701.34(b)(6)).
	(4) ***Availability to cover losses.*** Funds held by a credit union in a supplemental capital account, including interest accrued and paid into the supplemental capital account by the credit union, if any, must be available to cover operating losses realized by the credit union that exceed its net available reserves (exclusive of supplemental capital and allowance accounts for loan and lease losses), and to the extent funds are so used, the credit union must not restore or replenish the supplemental capital account under any circumstances. If a credit union is obligated to pay interest on a supplemental capital instrument it may, in lieu of paying interest on such instrument, pay accrued interest directly to the supplemental capital instrument investor or into a separate account from which such investor may make withdrawals. Losses must be distributed among supplemental capital accounts in accordance with the terms of the supplemental capital instruments to which such accounts relate.	This follows the LICU regulations (sec. 701.34(b)(7)). Proposed section 702.115(a)(5) makes explicit that the purpose of supplemental capital is to absorb losses without resorting to the NCUSIF.

	(5) ***Minimum maturity.*** A supplemental capital instrument may have a perpetual term. If a supplemental capital instrument has a stated maturity, the initial maturity period must be a minimum of five years.	This follows the LICU regulations (sec. 701.34(b)(4)), with the clarification that a supplemental capital instrument in the RBC context may have a perpetual term. The NCUA White Paper recommends that supplemental capital should demonstrate "a sufficient degree of permanence to warrant treatment as capital."[3] This provision would expressly authorize permanent capital instruments, such as mandatory membership capital, that carry a perpetual term, and provide a sufficient minimum maturity period for other, non-perpetual instruments.
	(6) ***Security.*** A supplemental capital instrument may not be pledged or provided by the supplemental capital instrument investor as security on a loan or other obligation with the credit union that issues it.	This follows the LICU regulations (sec. 701.34(b)(8)).
	(7) ***Merger.*** Unless otherwise provided by the terms of a supplemental capital instrument issued pursuant to an approved Supplemental Capital Plan or otherwise provided for in the merger agreement, in the event of a merger of a credit union, supplemental capital instruments will transfer to the continuing credit union.	This follows the corporate credit union regulations (sec. 701.34(b)(8)).
	(8) ***Purchase agreement.*** A supplemental capital purchase agreement must be executed by the supplemental capital instrument investor or an authorized representative of such investor, as appropriate, and an authorized representative of the credit union, reflecting the terms and conditions mandated by this section and any other terms and conditions not inconsistent with this section.	This follows the LICU regulations (sec. 701.34(b)(10)). The requirements for a purchase agreement and affirmative disclosure and acknowledgment under proposed section 702.115(a)(8)(ii) are meant to ensure that supplemental capital investors demonstrate understanding of the "risks, mechanics and limitations of

		supplemental capital accounts,"[4] as recommended by the NCUA White Paper.
	(9) ***Disclosure and acknowledgement.*** (i) The offer and sale of the supplemental capital instruments contemplated by this section is subject to the antifraud provisions of the federal securities laws which require full and adequate disclosure of material facts, including Section 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)) and Rule 10b-5 (17 CFR § 240.10b-5) of the Securities and Exchange Commission (SEC) promulgated under section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)). Credit unions shall comply with the antifraud provisions of the federal securities laws with respect to the offer and sale of supplemental capital instruments. It is the responsibility of credit union management to understand these requirements. The NCUA will review whether supplemental capital instrument investors have been provided sufficient disclosure of material facts by a credit union. Credit unions publicly offering supplemental capital instruments for sale shall use an offering circular that meets the requirements set forth in Appendix A to this section. (ii) An authorized representative of a credit union and of each supplemental capital instrument investor must execute a "Disclosure and Acknowledgment" as set forth in Appendix B to this section at the time of entering into the agreement contemplated by subparagraph (8) above. The credit union must retain an original of the purchase agreement and the "Disclosure and Acknowledgment" for the term of the agreement and a copy must be provided to the supplemental capital instrument investor.	This follows the FDIC's Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities (44 Fed. Reg. 39381, July 6, 1979; 61 Fed. Reg. 46808, September 5, 1996). Incorporating the substance of the FDIC policy statement as provided in this section incorporates important securities law obligations and ensures that manner of sale requirements apply to credit unions. Subsection (ii) follows the LICU regulations (sec. 701.34(b)(11)).
	(10) ***Investors and investor threshold.*** Supplemental capital instruments may be	To prevent concentration, the NCUA White Paper suggests a

	offered to members and non-members, at the discretion of the credit union issuing the instruments. Unless otherwise approved in writing by the NCUA, the aggregate value of all supplemental capital instruments of a credit union held by an individual supplemental capital instrument investor, together with its affiliates, shall not exceed [INSERT] percent of such credit union's net worth at the time of the offering. If a supplemental capital instrument investor is a special purpose entity, the assets of which consist predominantly of supplemental capital instruments issued by credit unions and related assets, the limitation set forth in this section shall be measured with respect to the ultimate beneficial owners of such instruments. If a supplemental capital instrument investor is a credit union, the aggregate value of all supplemental capital instruments held by such credit union, together with its affiliates, shall not exceed [INSERT] percent of such credit union's net worth.	single investor threshold of 5% of net worth for offerings of supplemental capital in the form of voluntary patronage capital.[5]
	(11) ***Aggregate threshold.*** Unless otherwise approved in writing by the NCUA, the aggregate value of all supplemental capital instruments offered by a credit union pursuant to this section shall not exceed [INSERT] percent of such credit union's retained earnings at the time of the offering.	Similar to the threshold for individual investors, an aggregate limit for supplemental capital assures a minimum level of core, non-supplemental capital (primarily retained earnings). The NCUA White Paper suggests an aggregate threshold of 2% of total assets for offerings of supplemental capital in the form of voluntary patronage capital.[6] However, tying the aggregate threshold to retained earnings as opposed to total assets reinforces that retained earnings continue to be the primary component of capital for credit unions.
	(12) ***Supplemental capital plan.***	This follows the LICU regulations (sec. 701.34(b)(1)).

(A) Before offering supplemental capital instruments, a credit union shall adopt, and submit to the NCUA, an application for approval of a "Supplemental Capital Plan" that: (i) Confirms that the issuance of supplemental capital instruments will not provide voting rights to non-members or otherwise alter the cooperative nature of the credit union; (ii) Confirms that the supplemental capital instruments offered under the plan satisfy or will satisfy the requirements of this section; (iii) States the maximum aggregate value of supplemental capital instruments the credit union shall offer; (iv) Identifies the purpose for which the aggregate supplemental capital shall be used, and, if applicable, how it shall be repaid; (v) Describes, if applicable, how the credit union shall provide for liquidity to repay supplemental capital instruments upon maturity; (vi) Demonstrates that the intended uses of supplemental capital conform to the credit union's strategic plan, business plan and budget; (vii) Describes the policies and procedures that the credit union has put in place to satisfy applicable federal and state securities law requirements, including any anti-fraud requirements; (viii) Describes the policies and procedures that the credit union has put in place to satisfy any applicable registration requirements or other	

	requirements related to the status of a credit union or its employees as a broker-dealer or investment adviser (including any policies and procedures put in place to ensure that such requirements do not apply to the activities of a credit union or its employees); (ix) Describes the policies and procedures that the credit union has put in place to assess its director and officer liability coverage and to ensure that it has sufficient policies in place at the time the supplemental capital instruments are offered; (x) Represents that the credit union will be categorized as [INSERT CAPITAL ADEQUACY CLASSIFICATION] or better at the time the supplemental capital instruments are offered; (xi) Includes supporting pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years; and (xii) Describes with specificity the following features of each issuance of a supplemental capital instrument, if applicable: 1) Maturity; 2) Interest and dividend features, including source of interest and dividend payments, and deferral options; 3) Call features; 4) Redemption features; 5) Credit-sensitive features;	

	6) Material covenants; 7) Any interest that the credit union itself would hold in the instrument, either directly or indirectly; 8) Accounting treatment; 9) Anti-dilution features; 10) Specific terms relating to the requirements set forth in §§ 702.115(a)(1)-(11), including, but not limited to, (A) any limitations on the eligibility of potential supplemental capital instrument investors and (B) samples of the purchase agreement, offering circular, "Disclosure and Acknowledgment," and any other disclosure materials that will be provided to such investors to satisfy the requirements of §§ 702.115(a)(8)-(9) and the appendixes to this section; 11) Whether the instruments will be issued as part of a participation with multiple issuers, which may involve the use of common securitization features (such as special purpose entities and pooled reserve	

accounts); and 12) Other features material to the NCUA's review. (B) The submission of a Supplemental Capital Plan shall be accompanied by an opinion of legal counsel which confirms that the issuance of supplemental capital instruments pursuant to such plan will not impair a credit union's exemption from federal income taxation under the Internal Revenue Code of 1986.	
(13) ***Decision on plan.*** If a credit union is not notified within [45] days of receipt of a complete application for approval of a Supplemental Capital Plan that the plan is approved or disapproved, the credit union may proceed to offer supplemental capital instruments pursuant to the plan. Provided that an issuance of supplemental capital instruments is consistent with the terms of a Supplemental Capital Plan approved or deemed approved under this subsection (a)(13), such issuance shall require further approval of the NCUA. The NCUA shall provide for a streamlined application and review process for Supplemental Capital Plans submitted by credit unions that are substantially similar (in terms of net worth classification, CAMEL ratings, etc.) to a credit union that has issued supplemental capital instruments pursuant to an approved Supplemental Capital Plan in which such credit unions propose to offer supplemental capital instruments that are functionally equivalent to those offered by the substantially similar credit union.	This follows the LICU regulations (sec. 701.34(b)(2)), with clarifications noting the ability to make subsequent "shelf" issuances of functionally equivalent supplemental capital instruments without prior NCUA approval and to provide for an expedited application and review process for functionally equivalent supplemental capital instruments offered by other credit unions.
(14) ***Amendment of plan.*** Any material amendment to a Supplemental Capital Plan shall be submitted to the NCUA at least [45] days prior to the date such amendment is proposed to take effect. If the NCUA has not objected to the amendment prior to the end of the notice period, the amendment may be	The LICU regulations do not include a provision to make amendments to the plan.

	adopted.	
	(15) ***Prohibited features.*** Supplemental capital instruments must not be subject to any provision or covenant that unduly restricts or otherwise acts to unduly limit the authority of a credit union or interferes with the NCUA's supervision of the credit union. Specifically, this would include a provision or covenant that: (i) Maintains a certain minimum amount in its capital accounts or other metric, such as minimum capital assets, liquidity, or loan ratios; (ii) Unreasonably restricts a credit union's ability to raise additional capital through the issuance of additional supplemental capital instruments or other regulatory capital instruments; (iii) Provides for default and acceleration of the supplemental capital instruments as the result of a change in control, if such change in control results from the NCUA's exercise of its statutory authority to require a credit union to merge with another financial institution; (iv) Requires the prior approval of a supplemental capital instrument investor in the case of a voluntary merger by a credit union where the resulting institution: (A) Assumes the due and punctual performance of all conditions of the supplemental capital instrument; and (B) Is not in default of the various covenants of the supplemental capital	This follows the OCC regulations (12 C.F.R. § 5.47(d)).

instrument; and (v) Provides for default and acceleration of the supplemental capital instrument as the result of a default by a subsidiary (including a limited liability company) of the credit union, unless: (A) There is a separate agreement between the subsidiary and the supplemental capital instrument investor; and (B) Such agreement has been reviewed and approved by the NCUA.	
(16) ***Notice of Issuance.*** (A) Credit unions shall notify the NCUA in writing within ten days after issuing supplemental capital instruments in accordance with an approved Supplemental Capital Plan that it intends to include in the risk-based capital ratio numerator under section 702.104(b)(1). A credit union may count such supplemental capital instruments toward its risk-based capital requirements unless the credit union has received notification from the NCUA that the supplemental capital instruments do not qualify for such purposes. (B) The notice must include: (i) The terms of the issuance; (ii) The amount and date of receipt of funds; (iii) A copy of the final subordinated note format and note agreement; and (iv) A statement that the issuance complies with all applicable laws and	This follows the OCC regulations (12 C.F.R. § 5.47(h)).

regulations.	
(17) ***Prompt corrective action.*** As provided in § 702.109(b)(15), the NCUA Board may prohibit a credit union classified as "critically undercapitalized" from paying principal, dividends or interest on its uninsured supplemental capital instruments, except that unpaid dividends or interest may continue to accrue under the terms of the instruments to the extent permitted by law.	This follows the LICU regulations (sec. 701.34(b)(12)).
(b) Accounting treatment; Recognition of risk-based capital value of supplemental capital instruments. (1) ***Debt or equity account.*** A credit union that offers supplemental capital instruments pursuant to paragraph (a) of this section must record the funds on its balance sheet in an appropriate debt or equity account entitled "uninsured supplemental capital accounts."	This follows the LICU regulations (sec. 701.34(c)(1)). Secondary capital issued by LICUs must be recorded in an equity account. Section 702.115(b)(1) reflects the fact that supplemental capital instruments may take the form of either equity or subordinated debt.
(2) ***Recognition of risk-based capital value.*** A credit union's reflection of the risk-based capital value of any supplemental capital accounts in its financial statement may never exceed the full balance of such supplemental capital accounts after any early repurchase or redemptions and losses. (3) ***Schedule for recognizing risk-based capital value.*** For supplemental capital instruments with remaining maturities of less than five years, a credit union must: (A) increase the interest rate on the instruments in accordance with a schedule included in its approved Supplemental Capital Plan; or (B) reflect the risk-based capital value of the related supplemental capital accounts in its financial statement in accordance with the lesser of: (i) The remaining balance of the supplemental capital accounts after any redemptions and losses; or	This follows the LICU regulations (sec. 701.34(c)(2)).

(ii) The amounts calculated based on the following schedule:

Remaining maturity	Value of original principal amount (percent)
Four to less than five years	[80%]
Three to less than four years	[60%]
Two to less than three years	[40%]
One to less than two years	[20%]
Less than one year	[0]

(4) ***Financial statement.*** The credit union must reflect the full amount of any supplemental capital accounts in a footnote to its financial statement.

This follows the LICU regulations (sec. 701.34(c)(3)).

(c) Redemption of Supplemental Capital.

(1) ***Request to redeem supplemental capital instrument.*** A request for approval to redeem a supplemental capital instrument may be submitted in writing to the NCUA at any time, must specify the instrument to be redeemed and the schedule for redeeming all or any part of each eligible instrument, and must demonstrate to the satisfaction of the NCUA that:

(i) The credit union will have a post-redemption net worth classification of "adequately capitalized" or better under Part 702 of this chapter;

(ii) The instrument was issued at least two years prior to the proposed redemption date;

(iii) The proceeds from the supplemental capital account will not

This follows the LICU regulations (sec. 701.34(d)(1)).

The NCUA White Paper recommends a restriction on early redemption in order to prevent collusion between the credit union and the investor, allowing exodus of capital when it may be needed to protect the NCUSIF.[7]

be needed to cover losses prior to final maturity of the instrument; (iv) The credit union's books and records are current and reconciled; (v) The proposed redemption will not jeopardize other current sources of funding, if any, to the credit union; and (vi) The request to redeem is authorized by resolution of the credit union's board of directors. The NCUA may waive one or more of these requirements in the case of a request for redemption in connection with an acquisition, merger, change in law, or other similar circumstance in which the NCUA determines that earlier redemption is appropriate.	
(2) ***Decision on request.*** A request to redeem a supplemental capital instrument may be granted in whole or in part. If a credit union is not notified within [45] days of receipt of a complete application for approval to redeem a supplemental capital instrument that its request is either granted or denied, the credit union may proceed with the redemption as proposed.	This follows the LICU regulations (sec. 701.34(d)(2)). For LICUs, NCUA's response is required within 45 days.
Amend § 702.109(b) by adding a new subparagraph (15) to read as follows: **§ 702.109 — Prompt corrective action for critically undercapitalized credit unions.** (15) Beginning [60] days after the effective date of classification of a credit union as [INSERT CAPITAL ADEQUACY CLASSIFICATION], prohibit payments of principal, dividends or interest on the credit union's supplemental capital instruments, except that unpaid dividends or interest shall continue to accrue under the terms of the instruments to the extent permitted by law.	This provision corresponds to proposed section 702.115(a)(17).

Appendix A to § 702.115 — Requirements for Offering Circulars. (A) The offering circular should include the following statements in capital letters printed in boldfaced type: THESE INSTRUMENTS ARE NOT SHARES OR DEPOSITS. THESE INSTRUMENTS ARE NOT INSURED BY THE NATIONAL CREDIT UNION ADMINISTRATION OR ANY OTHER AGENCY, AND ARE SUBJECT TO INVESTMENT RISK, INCLUDING THE POSSIBLE LOSS OF PRINCIPAL. THESE INSTRUMENTS HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE NATIONAL CREDIT UNION ADMINISTRATION NOR HAS THE NATIONAL CREDIT UNION ADMINISTRATION PASSED ON THE ADEQUACY OR ACCURACY OF THIS OFFERING CIRCULAR. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL. (B) The offering circular should indicate in capital letters and boldfaced type, if debt instruments are offered: THESE OBLIGATIONS ARE SUBORDINATE TO THE CLAIMS OF SHARE ACCOUNT HOLDERS AND DEPOSITORS AND OTHER CREDITORS AS MORE FULLY DESCRIBED IN THE OFFERING CIRCULAR. (C) The offering circular should identify the offeror and its principal business address; state the title, number, aggregate dollar amount and per unit price of supplemental capital instruments offered; describe the applicable rights and limitations, risk factors, business of the offeror, use of proceeds and capital structure, management, compensation and business transactions, material features of the supplemental capital instruments offered, the dividend policy for supplemental capital instruments (if applicable), the plan of distribution, any restriction on the aggregate value of all supplemental capital instruments of a credit union that may be held by an individual supplemental capital instrument investor, together with its affiliates, and legal or administrative proceedings; provide selected financial data for each of the last five fiscal years and interim periods, and a	Subsection (E) identifies several alternatives for satisfying the disclosure requirements under the proposed regulation, referencing the following existing securities law regimes: • **Regulation A:** Provides an exemption from registration requirements and a streamlined process for offerings of up to $50 million in a 12-month period, depending on the eligibility status of the issuer. • **Regulation D:** Provides an exemption from registration requirements for offerings, subject to restrictions on the number of unaccredited investors participating in the offering. • **563g Offerings:** 12 CFR part 563g incorporates the requirements for offerings by savings associations within the jurisdiction of the Office of the Comptroller of the Currency.

management's discussion and analysis of the results of operation for at least the past two years and the interim periods; and present comparative financial statements, footnotes and schedules of the credit union. Credit unions should include the most recent audited financial statements in the offering circular; *provided*, that the NCUA may waive the requirement that such financial statements be audited. Credit unions are encouraged to include an introductory "plain English" summary of the essential information contained in the offering circular, along with a profile of the terms of the offer and the telephone number of the principal executive offices of the credit union. (D) The offering circular should be accompanied by an order form that states the maximum purchase price per unit of supplemental capital instruments offered, the maximum and minimum number of supplemental capital instruments that may be purchased, the time period within which the purchase right must be exercised, any cancellation rights, any required method of payment, and any escrow arrangements. The order form should provide specifically designated blank spaces for dating and signing. Sales of supplemental capital instruments issued by a credit union should be conducted in a segregated area of the credit union's offices, whenever possible. Offers and sales should be conducted by authorized personnel, excluding tellers, in places where deposits are not ordinarily received. Any written advertisement, letter, announcement, film, radio, or television broadcast which refers to a present or proposed public offering of supplemental capital instruments covered by this section should contain: (a) a statement that the announcement is neither an offer to sell nor a solicitation of an offer to buy any of the supplemental capital instruments and that the offer may be made only by an offering circular, (b) the names and addresses of the credit union and the lead underwriter, if any, (c) the title of the supplemental capital instrument, the dollar amount and the number of instruments being offered, and the per unit offering price to the public, (d) instructions for obtaining an offering circular, and (e) a statement that the instruments are neither insured nor approved by the NCUA.	

(E) The disclosure requirements of this section are satisfied if:[8] (1) The offer and sale satisfy the information and disclosure requirements of SEC Regulation A (17 CFR part 230), or Regulation S-B (Small Business Issuers) (17 CFR part 228), (2) The supplemental capital instruments are offered and sold in a transaction that satisfies the requirements of SEC Regulation D (17 CFR 230.501-230.506), or (3) The supplemental capital instruments are offered and sold in a transaction that satisfies the information and disclosure requirements of 12 CFR part 563g.[9] (F) The requirements for offering circulars set forth in this appendix may be modified or waived by the NCUA, in its discretion.	
Appendix B to § 702.115 — Disclosure and Acknowledgement. A credit union that is authorized to issue supplemental capital instruments and each investor in such an instrument shall execute and date the following "Disclosure and Acknowledgment" form, a signed original of which must be retained by the credit union: <u>Disclosure and Acknowledgment</u>: [NAME OF CREDIT UNION] and [NAME OF INVESTOR] hereby acknowledge and agree that [NAME OF INVESTOR] has committed [AMOUNT OF FUNDS] in the form of a supplemental capital instrument issued by [NAME OF CREDIT UNION] under the following terms and conditions: 1. Term. If subject to a maturity period, the funds committed pursuant to the terms of the supplemental capital instrument are committed for a period of [INSERT] years. 2. Uninsured, non-share instrument. The supplemental capital instrument is not a share account and the funds committed pursuant to the terms of the supplemental capital instrument are not insured by the National Credit Union Share Insurance Fund or any other governmental or private entity.	

3. Availability to cover losses. The funds committed pursuant to the terms of the supplemental capital instrument and any interest paid on account of the instrument may be used by [NAME OF CREDIT UNION] to cover any and all operating losses that exceed the credit union's net worth exclusive of allowance accounts for loan losses, and in the event the funds are so used, [NAME OF CREDIT UNION] will under no circumstances restore or replenish those funds to [NAME OF INVESTOR]. Dividends are not considered operating losses and are not eligible to be paid out of supplemental capital. 4. Accrued interest. By initialing below, [NAME OF CREDIT UNION] and [NAME OF INVESTOR] agree that accrued interest will be: ____ Paid into and become part of the supplemental capital instrument; ____ Paid directly to the investor; ____ Paid into a separate account from which the investor may make withdrawals; ____ Any combination of the above provided the details are specified and agreed to in writing; or ____ Not accrue or be paid. 5. Subordination of claims. In the event of liquidation of [NAME OF CREDIT UNION], the funds committed pursuant to the terms of the supplemental capital instrument will be subordinate to all other claims on the assets of the credit union, including claims of member share account holders, creditors and the National Credit Union Share Insurance Fund. 6. Prompt Corrective Action. Under certain net worth classifications (see 12 CFR 702.109(b)(15), the NCUA may prohibit [NAME OF CREDIT UNION] from paying principal, dividends or interest on its uninsured supplemental capital instruments, except that unpaid dividends or interest will continue to accrue under the terms of the instrument to the extent permitted by law.	

ACKNOWLEDGED AND AGREED TO this _____ day of [MONTH AND YEAR] by: [NAME OF INVESTOR'S OFFICIAL] [TITLE OF OFFICIAL] [NAME OF INVESTOR] [ADDRESS AND PHONE NUMBER OF INVESTOR] [INVESTOR'S TAX IDENTIFICATION NUMBER] [NAME OF CREDIT UNION OFFICIAL] [TITLE OF OFFICIAL]	

[1] National Credit Union Administration, *Supplemental Capital White Paper*, Apr. 12, 2010 (the "NCUA White Paper").
[2] *Id.*, at 17.
[3] *Id.*, at 18.
[4] *Id.*, at 16.
[5] *Id.*, at 20, 23.
[6] *Id.*, at 20.
[7] *See id.*, at 18.
[8] Section 3(a)(5) of the Securities Act exempts from such statute "any security issued . . . by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by state or federal authority having supervision over any such institution." On its face, this language would appear to contemplate credit unions as a "similar institution," given the comprehensive regulation and supervision provided by NCUA and state banking regulators. And this is the approach that the SEC takes. The SEC has indicated: "The [SEC]'s staff interprets the 'similar institution' language in section 3(a)(5)(A) of the Securities Act to encompass credit unions whose accounts are insured by the National Credit Union Administration." *See, e.g.,* In re Idaho Central Credit Union (January 24, 1977) ('no action' letter from the Division of Corporation Finance)." SEC Release No. 33-6758 (March 3, 1988), 87-88 CCH Dec., FSLR ¶84,221.
[9] In addition to the amendment set forth above, conforming changes to other sections of the proposed RBC rule and the NCUA's regulations would be required. *See* Boeing Employees Credit Union, Comments on NCUA's Second Proposed Rule on Risk-Based Capital, Apr. 27, 2015, at app. 2.